THE BRITISH COLUMBIA RAILWAY GROUP OF COMPANIES ANNUAL REPORT FOR 1986

CORPORATE STATEMENT

Maintenance never ceases on lines constantly used by heavy freight and unit coal trains.

The British Columbia Railway group comprises three companies:

- British Columbia Railway Company, which holds investments in its two subsidiary companies —
- BCR Properties Ltd., which owns and manages the group's non-operating real estate assets and
- BC Rail Ltd., which is the group's railway operating company.

The Province of British Columbia is the sole shareholder of British Columbia Railway Company, which holds 100 per cent of the common shares of BCR Properties Ltd. BCR Properties owns 75 per cent of the common shares of BC Rail Ltd., the remaining 25 per cent of which are held by British Columbia Railway Company.

In 1984, BC Rail Ltd. offered eight million Series 1-A Preferred Shares for sale on Canadian stock exchanges, at a unit price of $25. The non-voting stock offer was fully-subscribed and the capital raised was used to acquire operating railway assets from British Columbia Railway Company which in turn, retired short-term borrowings.

The railway's principal sources of revenue are the transportation of forest industry-related products and coal from British Columbia's northeastern coalfields. All told, BC Rail operates and maintains 1,390 miles of main track between North Vancouver and its northernmost terminal in Fort Nelson, B.C.

BC Rail has online connections to all rail-served points in North America. Group assets exceed $1.2 billion.

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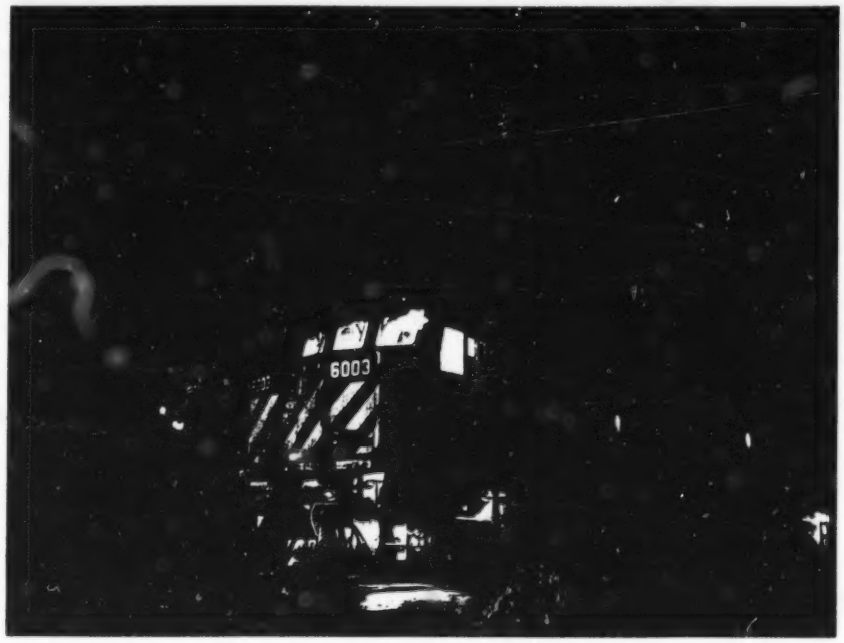


One of BC Rail's seven 6,000 h.p. electric locomotives loads northeast coal at Quintette load-out, near Tumbler Ridge.

BOARD OF DIRECTORS

J. Norman Hyland, *Chairman*
S. C. Cooper
Stanley M. Horner
E. Cecil Hurd
Valerie Kordyban
E. A. Moffat
M. C. Norris
Bruce Rome
Jack Weisgerber, MLA

OFFICERS

M. C. Norris, *President and Chief Executive Officer*
A. C. Sturgeon, *Senior Vice-President (Operations and Maintenance and Marketing and Sales)*
J. R. Clarke, *Vice-President - Finance*
Brian Foley, *Vice-President - Industrial Relations*
G. L. Ritchie, *Vice-President - Administration and Secretary*

FINANCIAL HIGHLIGHTS

	(Dollars in Thousands)	
	1986	1985
Operating revenues	**$313,447**	$294,600
Operating expenses	**$230,396**	$216,239
Operating income	**$83,051**	$78,361
Net income before minority interest	**$69,937**	$61,430
Net income	**$51,437**	$42,930
Carloadings	**235,697**	234,335
Total tons of freight hauled	**17,854,317**	17,831,967
Employees at year-end	**2,660**	2,620

DIRECTORS' REPORT

For 1986 the Directors are pleased to report a continuation of the profitable results which have been a feature of the Company's operating performance over the past five years.

While the forest industry dispute and the reduced demand for metallurgical coal by the Japanese steel industry had a negative influence on our operating environment, total revenues still increased by approximately six per cent. This increase, coupled with a steady improvement in operating efficiency and lower interest rates, enabled an increase in operating earnings and in net income. The details of the financial results are contained in the audited financial statements and are summarized in the President's Report.

From the Directors' standpoint, perhaps the most satisfying decision during the year was to initiate a common share dividend to the shareholder, the Province of British Columbia. An amount of $4.00 per share, or $10.3 million in total, was paid on May 9, 1986. As this was the first common share dividend in the 75-year life of the Railway it is regarded as a major achievement.

The Company continues to be a capital intensive enterprise and will remain so for the foreseeable future. Capital expenditures in 1986 were $53,898,000 and the capital budget for 1987 is $95.7 million. These expenditures have not required additional long-term debt.

A number of changes in the Company's Board of Directors took place during the year. Mr. John Kerr resigned early in the year to assume chairmanship of the B.C. Council of Forest Industries and Mr. Jack Heinrich, former Minister of Forests, resigned after deciding not to contest the fall provincial election. To both of these gentlemen we extend our thanks for their participation and counsel in the affairs of the Company.

Mr. Kerr was succeeded by Ms. Valerie Kordyban, of Prince George, and Mr. Heinrich was temporarily succeeded by Mr. Jack Kempf. Soon after the September election, however, Mr. Kempf was succeeded by Mr. Jack Weisgerber, the member for South Peace River.

The results reported for 1986 are testimony to the experience and the management and operating skills of a well motivated workforce at all levels. To the senior management and the 2,600 employees who operate the trains, maintain the line and the equipment, keep the financial and operating records and all the other required tasks, the Board expresses gratitude and recognition for a successful year.

This Annual Report contains much useful and interesting information about the Company's operations and we recommend its reading to our shareholders.

On behalf of the Board of Directors.

J. N. Hyland

J. N. Hyland, *Chairman*

PRESIDENT'S REPORT

I am pleased to report improved consolidated operating income for the fifth consecutive year.

Before recognition of minority interest — the payment of dividends to preferred shareholders — net income for the British Columbia Railway group amounted to $69.9 million, compared with $61.4 million for the preceding fiscal year. Retained earnings at the close of 1986 were $84.1 million, against $42.9 million in 1985.

While the result is encouraging, net income continues to fall short of an acceptable rate of return on investment. Nineteen-eighty-six net income after minority interest was $51.4 million, against $42.9 million in 1985 — a return of four per cent on a net investment of $1.26 billion and a return of six per cent on equity. An acceptable rate of return on net investment for North American railways is 12 to 15 per cent.

However, it is rewarding that the group's performance continues to improve. Without doubt, much of the improvement can be attributed to the railway's increased operational efficiency which is due both to the very substantial investments in upgrading and modernizing the physical plant over the last dozen years and improved operational controls.

It is gratifying to report also, that the debt position of the railway has continued to improve since the corporate reorganization in June 1984. In total, the company's outstanding debt has been reduced from $411 million in June 1984, to $327 million by the end of 1986.

The company's operating revenues for 1986 totalled $313.4 million, compared with $294.6 million in the previous year. Operating expenses for the year were $230.4 million, against $216.2 million in the previous year.

The combined effects of a three-month forest industry dispute and prolonged hearings concerning U.S. lumber tariffs undoubtedly had a negative effect on the railway's overall performance.

Coal shipments from northeastern B.C. declined by 5,885 carloads from the previous year and at year-end, only seven of nine coal train sets were in use. It is unfortunate that the reduced demand for coal in Japan has resulted in no return from the capital employed in these two unit trains.

I am conscious too, that the strong U.S. housing markets we have enjoyed for several years — the result of matured 'baby-boomers' establishing homes — are now softening and that in due course, we may experience a slowdown in demand for British Columbia's wood products. For the first time in several years, carloadings in 1986 did not significantly increase.

Because the railway's own financial health rises and falls with that of its customers, we must maintain our efforts to help shippers remain competitive and to that end, our search for improvements in efficiency and productivity will continue.

While the British Columbia economy overall has been slow to advance, I am optimistic that 1987 will be a successful operating year for the railway. I believe shippers located on BC

Rail will rise to the challenge of these changing market conditions and that, in general, short-term prospects are good.

I would like to extend my congratulations to my fellow Board members, our Chairman Mr. J. Norman Hyland; Mr. Stanley M. Horner; Mr. E. Cecil Hurd and Mr. Bruce Rome, on their completion of 10 years service as directors. Their counsel and encouragement over the years have been invaluable and I continue to be grateful for their support.

On a sadder note, I am sorry to report the death of our former Vice-President — Operations and Maintenance, Mr. Norman A. McPherson, who died in December following a long and difficult illness. Mr. McPherson retired a year earlier for reasons of poor health. He is sadly missed by us all. In recognition of Mr. McPherson's contribution to the railway, the Norman McPherson Scholarship Fund has been established. This fund will provide annual scholarships for the sons or daughters of BC Rail employees.

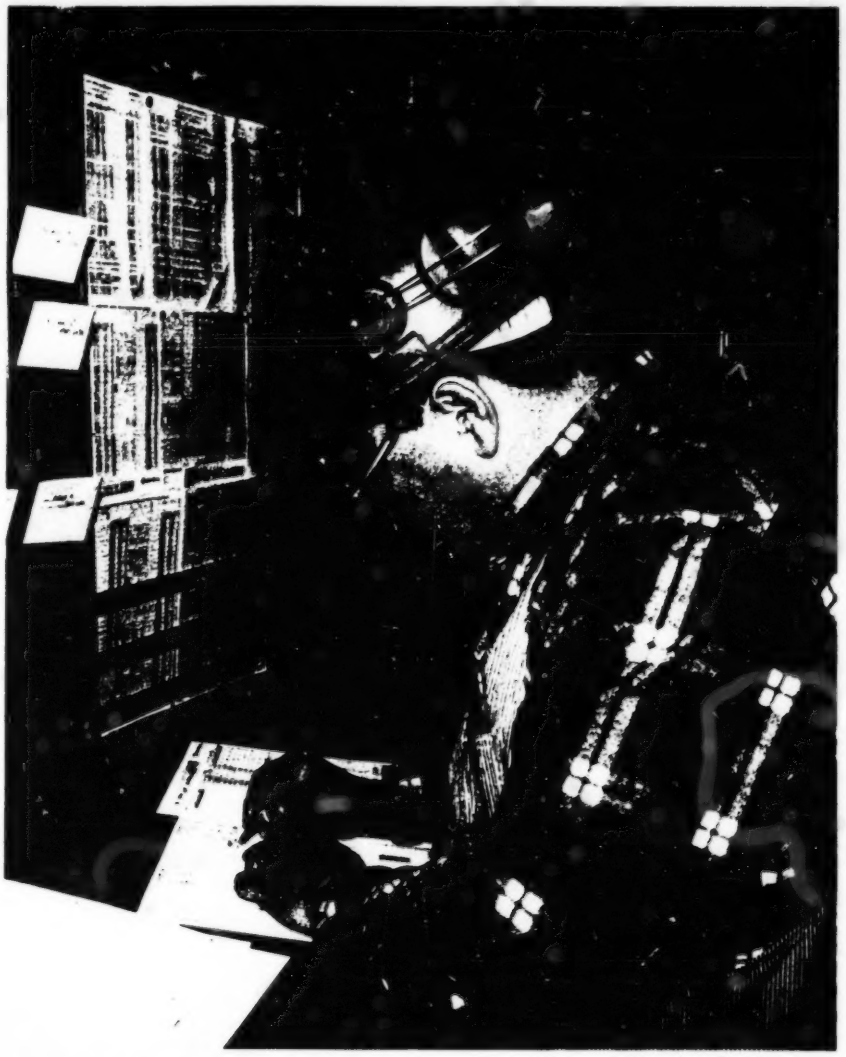
During the year, Mr. Arnold C. Sturgeon was appointed to the position of Senior Vice-President, with responsibilities for two divisions, Marketing and Sales and Operations and Maintenance. Mr. Sturgeon formerly was Vice-President — Marketing and Sales.

Following the release of Mr. Justice René Foisy's report on the catastrophic rail accident at Hinton, Alberta, BC Rail has accelerated its program to install reset safety control devices in all locomotives. Target date for completion of the program has been set for the end of 1987.

Among other safety measures, BC Rail will also intensify the frequency and scope of its train crew efficiency testing program, which is designed to monitor performance and the observance of operating rules.

I am pleased to report also that the railway's safety record overall continues to improve and that in 1986, the incidence of lost-time injuries declined to an all-time low. I compliment employees at all levels for their diligence and this outstanding achievement.

In the year of our 75th anniversary, I must once again thank my fellow employees for their support during the past year. The railway has made enormous progress since it was incorporated on February 27th, 1912. It could not have done so without the backing of a dedicated and competent workforce.



Employee safety performance continues to improve. Nineteen-eighty-six brought record low for lost-time injuries.

M.C. Norris

M.C. Norris, *President and Chief Executive Officer*

YEAR IN REVIEW

The British Columbia Railway once again experienced substantial improvements in consolidated financial results.

While performance for the first nine months of the year was the strongest ever recorded, a forest industry labour dispute and market uncertainty during softwood tariff negotiations led to a traffic fall-off in the final quarter.

The industrial dispute lasted for nearly four months and the U.S.-Canada tariff negotiations continued beyond year-end, when an agreement was concluded.

Throughout the disputes, U.S. housing starts were strong and demand for B.C. lumber remained relatively high. An increased demand for interior woodchips by B.C. coastal pulp mills — whose supply had been interrupted by the labour dispute — also helped to keep BC Rail traffic at relatively high levels during the last three months of the year.

Northeastern coal traffic declined by approximately seven per cent, the result of volume reductions permitted under contracts between mines and Japanese customers. While shipments declined by 5,885 carloads, the railway nevertheless carried 7.9 million tons of coal, against 8.4 million tons the year before and coal traffic contributed significantly to this successful year of operation.

Total carloadings increased marginally, from 234,335 in 1985 to 235,697, and total freight carried rose from 17,831,967 to 17,854,317 tons. The railway's efforts to retain its share of market against competitive modes and carriers continue to be a high priority.

Near the end of the year, a series of rockslides south of Lillooet caused a 13-day closure of the mainline and a major diversion of traffic. The geology of the region is causing concern and an engineering study is in progress.

With completion of the final year of a major, four-year upgrading program on the Prince George to Anzac mainline, the railway infrastructure associated with the unit train movement of northeast coal is now in place.

As well as overall track and roadbed improvements, the upgrade program included installation of 70 miles of heavier gauge, continuous welded rail. The continuous welded rail replacement program, which now totals 144 miles, or approximately 10 per cent of the railway's mainline trackage, will be extended as time progresses and as opportunities occur.

The railway also carried out major track work on the Williams Lake, Fort Nelson, Dawson Creek and Fort St. James subdivisions as part of its continuing upgrading and modernization program.

During the year, the railway purchased a new rail grinding machine which has since been operated at various points throughout the system. Grinding extends rail life and significant economies are anticipated from its use.

Construction of a new waferboard plant in BC Rail's Dawson Creek industrial park is well under way and it is anticipated that incremental traffic of eight to 10 daily carloads of the product will commence in May, 1987. Ground was also broken in Dawson Creek for a new ethanol

New passenger and freight terminal was officially opened in Lillooet during the year.

plant, which also is expected to generate additional traffic when production begins. Ethanol is a gasoline additive derived from grain.

BC Rail passenger trains carried 80,183 passengers in 1986, compared with 79,122 in 1985. Expected growth during Expo 86 did not materialize because in general, world's fair visitors did not travel beyond Vancouver. Nevertheless, refurbishing of the railway's passenger car fleet continues and in efforts to stimulate traffic, the company is working with local and overseas tour operators with a view to further development.

During the year, the railway enjoyed excellent co-operation from its organized employees and the end of 1986 marked nearly seven years of uninterrupted operation. Contract negotiations with the railway's joint council of trade unions are scheduled to begin in the spring of 1987.

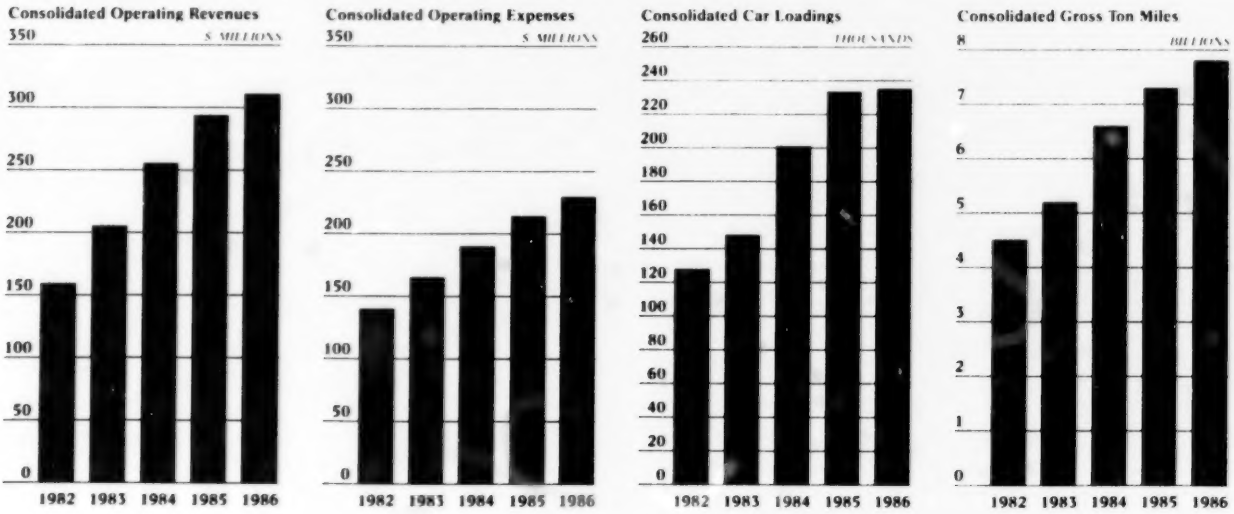
Nineteen-eighty-six was also the seventh consecutive year of improvement in employee safety statistics and an accident frequency rate of 21 injuries per million man hours — down from 27 per million man-hours in 1985 — represents an improvement of no less than 69 per cent over the seven-year period. By any measure, this is an outstanding achievement by all employees, which indicates that safety in the workplace is a major concern at every level.

During the year, the company developed a long-term motive power fleet management plan, based on carloading forecasts and projected business levels. BC Rail's current locomotive fleet comprises 116 units.

BC Rail was a corporate sponsor of Vancouver's highly successful world's fair, Expo 86. A continuing exchange of information with visiting railway, governmental and transportation officials from all over the world helped to increase awareness of the railway, both at home and overseas.

The second and final phase of the company's new corporate identity program was implemented during the year and adoption of a new logotype and standardized signage is now virtually complete. Locomotives and other wheeled equipment will be progressively changed as repainting falls due.

Nineteen-eighty six was the railway's 74th year of operation, its predecessor the Pacific Great Eastern Railway having been incorporated on February 27th, 1912. Preparations began in the latter part of the year for a number of 75th anniversary activities scheduled to be held during 1987.



BC Rail hauled 7.9 million tons of northeast coal in unit trains like this.

Grain cars at Fort St. John. Federal Western Grain Transportation Act offers incentive to develop such traffic.

BC Rail's intermodal services department operates a large fleet of tractors and trailers.

Pulping woodchip traffic was a major contributor to 1986 revenues.

BRITISH COLUMBIA RAILWAY COMPANY CONSOLIDATED FINANCIAL STATEMENTS

BRITISH COLUMBIA RAILWAY COMPANY
MANAGEMENT REPORT

The consolidated financial statements of British Columbia Railway Company have been prepared by management in accordance with generally accepted accounting principles in a manner consistent with the previous year. Management is responsible for the accuracy, integrity and objectivity of the information contained in the financial statements and to ensure that the presentation conforms with generally accepted accounting principles.

The independent auditors, Peat, Marwick, Mitchell & Co., have been appointed by the Lieutenant Governor in Council to express an opinion as to whether these consolidated financial statements present fairly the company's financial position and operating results in conformity with generally accepted accounting principles consistently applied. Their report outlines the scope of their examination and gives their opinion on the fairness of the statement presentation.

The Audit Committee of the company directors appointed by the Board meets periodically with financial officers of the company and the external auditors to ensure that each group is fulfilling its obligations and to review and approve the annual financial statements prior to their release.

Management maintains an extensive system of internal accounting controls and believes that transactions are accurately recorded on a timely basis, are properly approved and result in reliable financial statements. The adequacy and operation of the control systems are monitored on an on-going basis by an internal audit department.

The consolidated financial statements have, in the opinion of the management of the company, been properly prepared within reasonable limits of materiality and within the framework of the accounting policies summarized in Note 1 of the Notes to financial statements.

AUDITORS' REPORT

To the Lieutenant Governor
in Council
Province of British Columbia

We have examined the consolidated balance sheet of British Columbia Railway Company as at December 31, 1986 and the consolidated statements of income and retained earnings and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its cash position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.

Peat, Marwick, Mitchell & Co.
Chartered Accountants

Vancouver, British Columbia
Canada
March 2, 1987

BRITISH COLUMBIA RAILWAY COMPANY
CONSOLIDATED BALANCE SHEET

	(Dollars in Thousands) December 31	
	1986	1985
Assets		
Current assets		
Cash	$ 712	$ 10,454
Accounts receivable	51,027	53,539
Material and other items	30,451	35,181
	82,190	99,174
Property and equipment		
Road and buildings	1,076,404	1,043,446
Equipment	254,099	248,858
	1,330,503	1,292,304
Accumulated depreciation	247,069	219,996
	1,083,434	1,072,308
Dease Lake extension — Note 2	98,020	98,020
	$1,263,644	$1,269,502
Liabilities and Shareholder's Equity		
Current liabilities		
Accounts payable	$ 83,443	$ 109,585
Current obligations on long-term debt	1,441	1,329
	84,884	110,914
Deferred income taxes	517	(1,621)
Long-term debt — Note 3	125,780	148,875
Minority interest — Note 4	200,000	200,000
Shareholder's equity		
Share capital — Note 5	257,688	257,688
Contributed surplus	510,716	510,716
Retained earnings	84,059	42,930
	852,463	811,334
Commitments — Note 6		
Contingent liabilities — Note 7		
	$1,263,644	$1,269,502

On behalf of the Board

S.M. Horner, *Director*

M.C. Norris, *Director*

BRITISH COLUMBIA RAILWAY COMPANY
CONSOLIDATED INCOME AND RETAINED EARNINGS

	(Dollars in Thousands) For the year ended December 31	
	1986	1985
Revenues	**$313,447**	$294,600
Expenses		
Equipment	**69,698**	63,102
Operations	**67,928**	67,424
Road	**46,460**	38,468
Depreciation	**32,359**	30,425
Other	**24,046**	23,438
Government assistance – Note 8	**(10,095)**	(6,618)
	230,396	216,239
Railway operating income	**83,051**	78,361
Non-operating income (expense)		
Interest – Note 9	**(13,687)**	(18,442)
Other income	**2,711**	1,844
	(10,976)	(16,598)
Net income before deferred income taxes	**72,075**	61,763
Provision for deferred income taxes – Note 10	**2,138**	333
Net income before minority interest	**69,937**	61,430
Minority interest	**18,500**	18,500
Net income	**51,437**	42,930
Retained earnings, beginning of year	**42,930**	–
	94,367	42,930
Dividends	**10,308**	–
Retained earnings, end of year	**$ 84,059**	$ 42,930

BRITISH COLUMBIA RAILWAY COMPANY
CONSOLIDATED CASH FLOW

	(Dollars in Thousands) For the year ended December 31	
	1986	1985
Operating activities		
Net income	**$ 51,437**	$ 42,930
Add (deduct)		
Items not affecting working capital		
Depreciation and amortization	**32,359**	30,425
Deferred income taxes	**2,138**	333
Net changes in non-cash working capital balances		
Accounts receivable	**2,512**	(13,935)
Material and other items	**4,730**	(3,378)
Accounts payable	**(24,461)**	26,307
Interest	**13,687**	18,442
Cash provided by operations	**82,402**	101,124
Investing activities		
Additions to property and equipment	**(53,898)**	(33,091)
Change in payables for equipment purchases	**(1,681)**	(2,464)
Government assistance for capital items	**10,413**	749
	(45,166)	(34,806)
Financing activities		
Issue of long-term debt	**—**	192,123
Repayment of long-term debt	**(22,983)**	(239,194)
Interest	**(13,687)**	(18,442)
	(36,670)	(65,513)
Dividends paid	**(10,308)**	—
Increase (decrease) in cash	**(9,742)**	805
Cash, beginning of year	**10,454**	9,649
Cash, end of year	**$ 712**	$ 10,454

BRITISH COLUMBIA RAILWAY COMPANY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 1986

1. Significant Accounting Policies

The accounting regulations prescribed by the Canadian Transport Commission for Canadian railways have been adopted to the extent that this is possible without submitting specific accounting policies and depreciation rates to the Commission for approval.

Basis of consolidation

The consolidated financial statements include the accounts of British Columbia Railway Company and its subsidiaries BC Rail Ltd. and BCR Properties Ltd. In these notes "company" refers to British Columbia Railway Company and its subsidiaries. All significant inter-company transactions are eliminated.

Class of business

The company provides a fully integrated rail freight service within British Columbia. Services other than hauling freight are not of sufficient size to warrant separate reporting.

Road property

New construction is recorded at cost net of Government grants. Abandoned or relocated sections are removed at average unit costs. Elements of track structure installed during planned programs are recorded at cost and the material replaced is removed at amounts which approximate average unit costs. Labour costs for programmed replacements are expensed as incurred.

All costs of constructing rail lines are capitalized to the date the line is certified operational by the British Columbia Ministry of Transportation and Highways. Capitalization of interest ceases and provision of depreciation commences on the date of certification.

Depreciation

Depreciation is provided for major categories of property and equipment on the straight-line basis at composite rates estimated to reduce the original cost to estimated salvage value over the average service lives of the classes. The group method is used for recording depreciation under which, on disposal, the original cost of assets retired less salvage value is charged against accumulated depreciation. No gain or loss on retirements, other than on accidental destruction of rolling stock and on disposal of land, is included in income. The original cost of assets less estimated salvage value is depreciated over the following number of years:

	Number of years
Grades, surfacing and tunnels	100
Rails	35
Ties	15
Ballast	25
Bridges	30-80
Locomotives and power units	25
Freight cars	33

Repairs

Repairs and non-programmed replacements of track structure are charged against current operations. Betterments and major track relocations are capitalized.

Material and supplies

Inventories of material and supplies are valued at the lower of average cost and net realizable value.

Government assistance

Grants directly related to the construction or rehabilitation of road property have offset related road property capital expenditures. Operating assistance has been deducted from the related expense accounts or included in revenue.

Income taxes

Income tax expense is computed on the basis of accounting income recorded by BC Rail Ltd. No taxes are currently payable as BC Rail Ltd. intends to claim certain amounts for income tax purposes in excess of those recorded in the accounts. British Columbia Railway Company and BCR Properties Ltd. are exempt from Canadian federal and provincial income taxes.

Transactions in foreign currency

Transactions originating in foreign currency are translated at the approximate exchange rates prevailing at the dates of the transactions. Assets and liabilities denominated in foreign currency at the balance sheet date are translated to equivalent Canadian amounts at the current rate of exchange.

Leases

Certain long-term lease transactions relating to the financing of equipment are accounted for as purchases. The capital lease obligations reflect the present value of future minimum rental payments discounted

NOTES

at the interest rate implicit in the leases. The capitalized values of depreciable assets are generally depreciated over the related lease terms in equal annual amounts. Costs of all other leases are charged against operations as incurred.

2. Dease Lake Extension

These costs consist of charges relating to the uncompleted Dease Lake extension. Construction was suspended in 1977 and there are no commitments to continue. In the event any portion of this extension is abandoned, the cost less any value recovered will be written off at that time.

3. Long-Term Debt

Long-term debt outstanding, less current maturities, consists of the following:

	1986	1985
Sinking fund bonds and debentures payable to the Province of British Columbia (the Province)		
11% due June 1995	**$ 25,000,000**	$ 25,000,000
10.99% due August 2005	**24,490,000**	24,490,000
	49,490,000	49,490,000
Less sinking fund	**199,000**	—
	49,291,000	49,490,000
Bond payable to the Province 10.75% due February 1990	**25,000,000**	25,000,000
Capital lease obligations — Notes 6 and 12	**42,137,000**	43,327,000
	116,428,000	117,817,000
Deduct current portion	**1,441,000**	1,329,000
	114,987,000	116,488,000
Notes payable to the Province	**10,793,000**	32,387,000
	$125,780,000	$148,875,000

The notes payable to the Province are arranged under a borrowing agreement between British Columbia Railway Company and the Province. The present notes outstanding bear interest at rates between 8.11% and 8.43%.

4. Minority Interest

The minority interest consists of 8,000,000 series 1-A first preferred shares with a par value of $25 each issued by BC Rail Ltd. These shares are designated as $2.3125 cumulative, redeemable and retractable.

BC Rail Ltd. must make all reasonable efforts in each quarter to purchase for cancellation in the open market three-quarters of 1% of the series 1-A preferred shares outstanding at the beginning of the quarter at a price not to exceed $25 per share and all transaction costs. If it is unable to fulfill its obligation in any calendar quarter the obligation will carry over only to the successive calendar quarters of the same calendar year and will thereafter be extinguished. During 1986 the company was unable to purchase shares at a price not exceeding $25 per share.

5. Share Capital

Authorized

10,000,000 shares with a par value of $100 each.

Issued

2,576,885 shares are outstanding and held by the Province.

As all of the shares are held by the Province earnings per share has not been provided.

NOTES

6. Commitments

The company has significant lease commitments for rolling stock and additional minor lease commitments for equipment and real estate which expire at various dates prior to the year 2000. Certain of these leases transfer substantially all of the benefits and risks of ownership to the company and are accounted for as capital assets.

The following is a schedule of future minimum rental payments at December 31, 1986 required under non-cancellable leases that have terms in excess of one year.

	Capital leases	Operating leases
1987	$ 6,555,000	$ 16,299,000
1988	6,555,000	15,851,000
1989	6,555,000	15,441,000
1990	6,555,000	13,865,000
1991	6,555,000	12,385,000
Later years	56,246,000	37,191,000
Total minimum lease payments	89,021,000	$111,032,000
Less		
Executory costs	4,093,000	
Imputed interest	42,791,000	
Present value	$42,137,000	

Assets under capital leases recorded in the property and equipment accounts as at December 31, 1986 are as follows.

Equipment	$46,597,000
Accumulated depreciation	11,326,000
	$35,271,000

As at December 31, 1986 the company had outstanding purchase commitments for the acquisition of material and equipment amounting to $10,000,000.

7. Contingent Liabilities

The company is contingently liable with respect to pending litigation and claims which arose in connection with construction of the Tumbler Ridge rail line and in the normal course of business. In the opinion of management any liability that may arise will be capitalized or would not have a material adverse effect on future income.

8. Government Assistance

Government assistance was as follows.

	1986	1985
Carried forward from previous year	$ 239,000	$ 1,031,000
Contributions during the year		
From the Province		
Fort Nelson extension		
Operating	4,500,000	3,456,000
Rehabilitation	6,599,000	49,000
Passenger operation	2,400,000	2,100,000
Passenger car modernization	527,000	170,000
Other	635,000	800,000
	14,661,000	6,575,000
From the Government of Canada		
Grain transportation	2,769,000	879,000
Rail line rehabilitation	6,250,000	—
Rail line electrification	125,000	—
	23,805,000	7,454,000
	24,044,000	8,485,000
Applied as follows		
Revenue	2,769,000	879,000
Operating expenses	10,095,000	6,618,000
Property and equipment	10,413,000	749,000
	23,277,000	8,246,000
Carried forward to following year	$ 767,000	$ 239,000

NOTES

9. Interest Expense

Interest expense was as follows:

	1986	1985
Interest on long-term debt and notes to the Province	$ 9,675,000	$14,323,000
Less		
Sinking fund earnings	8,000	—
Interest earned on temporary investments	1,077,000	1,150,000
	1,085,000	1,150,000
	8,590,000	13,173,000
Interest on capital lease obligations	5,097,000	5,269,000
Net interest	$13,687,000	$18,442,000

10. Income Taxes

The effective tax rate differs from the rate of 53.8% applicable to British Columbia companies because the net income of British Columbia Railway Company and BCR Properties Ltd. is exempt from federal and provincial income taxes. The net income before taxes of BC Rail Ltd., which was $3,974,000 (1985 — $629,000), is subject to federal and provincial income taxes.

11. Pension Plan

The majority of the company's employees participate in a contributory pension plan and are entitled to limited vested rights prior to retirement. An actuarial valuation as at May 31, 1986 disclosed that the plan was fully funded.

12. Related Party Transactions

Related party information not included elsewhere in the notes to financial statements is presented below.

First preferred shares of BC Rail Ltd. and certain capital lease obligations are guaranteed by the Province. The Ministry of Finance of the Province acts as fiscal agent in the administration of the debt and the Superannuation Commission of the Province administers the company pension plan. Fees are charged for both of these services.

Except as described in Note 10, the company is subject to all taxes levied by the Province other than property and capital taxes. All other transactions between the company and the Province are at terms no more or less favourable than those with unrelated parties.

FIVE YEAR REVIEW

(Dollars in Thousands)

	FISCAL YEAR				
CONSOLIDATED STATEMENT	**1986**	1985	1984	1983	1982
Revenues	**$313,447**	$294,600	$256,108	$205,446	$ 59,696
Expenses					
Equipment	**69,698**	63,102	58,099	56,468	45,281
Operations	**67,928**	67,424	57,028	52,432	46,883
Road	**46,460**	38,468	33,693	29,372	25,759
Depreciation	**32,359**	30,425	26,520	18,312	17,436
Other	**24,046**	23,438	19,076	16,682	15,183
Government assistance	**(10,095)**	(6,618)	(5,217)	(7,772)	(8,725)
	230,396	216,239	189,199	165,494	141,817
Railway operating income	**83,051**	78,361	66,909	39,952	17,879
Non-operating income (expense)					
Interest	**(13,687)**	(18,442)	(46,990)	(48,633)	(52,303)
Debt servicing assistance	**—**	—	22,475	46,367	49,985
	(13,687)	(18,442)	(24,515)	(2,266)	(2,318)
Other income	**2,711**	1,844	1,636	2,281	3,023
	(10,976)	(16,598)	(22,879)	15	705
Net income before deferred income taxes	**72,075**	61,763	44,030	39,967	18,584
Provision for deferred income taxes	**2,138**	333	1,343	—	—
Net income before minority interest	**69,937**	61,430	42,687	39,967	18,584
Minority interest	**18,500**	18,500	8,345	—	—
Net income	**$ 51,437**	$ 42,930	$ 34,342	$ 39,967	$ 18,584
OPERATING STATISTICS					
Total revenue cars loaded on line	**232,367**	232,115	197,643	145,571	126,031
Received from connections	**3,330**	2,220	2,614	3,198	2,546
Total carloadings	**235,697**	234,335	200,257	148,769	128,577
MOTIVE POWER					
Electric locomotives	**7**	7	7	7	—
Diesel locomotives	**109**	110	115	123	126
ROLLING STOCK FLEET					
Freight cars	**10,146**	9,960	10,060	9,690	9,811
Passenger cars	**9**	9	9	9	6
Boarding and work cars	**455**	452	469	446	493
TONS HAULED	**17,854,317**	17,831,967	14,672,412	9,347,197	8,023,581
EMPLOYEES AT YEAR END	**2,660**	2,620	2,640	2,600	2,400

Opposite: Nineteen-eighty-six was the final year of a four year upgrading program on the Prince George-Anzac section of the mainline.

BC RAIL LTD.
FINANCIAL STATEMENTS

BC RAIL LTD.
MANAGEMENT REPORT

The financial statements of BC Rail Ltd. have been prepared by management in accordance with generally accepted accounting principles in a manner consistent with the previous year. Management is responsible for the accuracy, integrity and objectivity of the information contained in the financial statements and to ensure that the presentation conforms with generally accepted accounting principles.

The independent auditors, Peat, Marwick, Mitchell & Co., have been appointed by the Shareholders to express an opinion as to whether these financial statements present fairly the company's financial position and operating results in conformity with generally accepted accounting principles consistently applied. Their report outlines the scope of their examination and gives their opinion on the fairness of the statement presentation.

The Audit Committee of the company directors appointed by the Board meets periodically with financial officers of the company and the external auditors to ensure that each group is fulfilling its obligations and to review and approve the annual financial statements prior to their release.

Management maintains an extensive system of internal accounting controls and believes that transactions are accurately recorded on a timely basis, are properly approved and result in reliable financial statements. The adequacy and operation of the control systems are monitored on an on-going basis by an internal audit department.

The financial statements have, in the opinion of the management of the company, been properly prepared within reasonable limits of materiality and within the framework of the accounting policies summarized in Note 1 of the Notes to financial statements.

AUDITORS' REPORT

To the Shareholders

We have examined the balance sheet of BC Rail Ltd. as at December 31, 1986 and the statements of income and retained earnings, contributed surplus and cash flow for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these financial statements present fairly the financial position of the company as at December 31, 1986 and the results of its operations and the changes in its cash position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.

Peat, Marwick, Mitchell & Co.
Chartered Accountants

Vancouver, British Columbia
Canada
March 2, 1987

BC RAIL LTD.
BALANCE SHEET

	(Dollars in Thousands) December 31	
	1986	1985
Assets		
Current assets		
Cash	$ 712	$ 10,452
Accounts receivable	50,627	53,539
Material and other items	30,366	34,545
Due from British Columbia Railway Company	63,349	36,903
	145,054	135,439
Property and equipment		
Road and buildings	1,073,077	1,040,200
Equipment	254,099	248,858
	1,327,176	1,289,058
Accumulated depreciation	247,069	219,996
	1,080,107	1,069,062
Dease Lake extension — Note 2	98,020	98,020
	$1,323,181	$1,302,521
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	$ 81,222	$ 107,364
Current obligations on long-term debt	1,249	1,137
Due to BCR Properties Ltd.	33,873	31,565
	116,344	140,066
Deferred income taxes	517	(1,621)
Long-term debt — Note 3	701,645	640,737
Shareholders' equity		
Share capital — Note 4	411,690	411,690
Contributed surplus	92,655	113,155
Retained earnings (deficit)	330	(1,506)
	504,675	523,339
Commitments — Note 5		
Contingent liabilities — Note 6		
	$1,323,181	$1,302,521

On behalf of the Board

S.M. Horner, *Director*

M.C. Norris, *Director*

BC RAIL LTD.
INCOME AND RETAINED EARNINGS

	(Dollars in Thousands) For the year ended December 31	
	1986	1985
Revenues	**$313,447**	$294,600
Expenses		
Equipment	**69,698**	63,102
Operations	**67,928**	67,424
Road	**46,460**	38,468
Depreciation	**32,359**	30,425
Other	**23,092**	23,378
Government assistance — Note 7	**(10,095)**	(6,618)
	229,442	216,179
Railway operating income	**84,005**	78,421
Non-operating income (expense)		
Interest — Note 8	**(80,468)**	(78,065)
Other income	**437**	273
Net income before deferred income taxes	**3,974**	629
Provision for deferred income taxes	**2,138**	333
Net income	**1,836**	296
Deficit, beginning of year	**1,506**	1,802
Retained earnings (deficit), end of year	**$ 330**	$ (1,506)

BC RAIL LTD.
CONTRIBUTED SURPLUS

	(Dollars in Thousands) For the year ended December 31	
	1986	1985
Balance, beginning of year	**$113,155**	$133,655
Dividends paid		
Preferred shares	**18,500**	18,500
Common shares	**2,000**	2,000
	20,500	20,500
Balance, end of year	**$ 92,655**	$113,155

BC RAIL LTD.
CASH FLOW

	(Dollars in Thousands) For the year ended December 31	
	1986	1985
Operating activities		
Net income	**$ 1,836**	$ 296
Add (deduct)		
Items not affecting working capital		
Depreciation and amortization	**32,359**	30,425
Deferred income taxes	**2,138**	333
Net changes in non-cash working capital		
Accounts receivable	**2,912**	(13,935)
Material and other items	**4,179**	(2,767)
Accounts payable	**(24,461)**	24,088
Intercompany accounts	**(24,138)**	(24,414)
Interest	**80,468**	78,065
Cash provided by operations	**75,293**	92,091
Investing activities		
Additions to property and equipment	**(53,817)**	(33,101)
Change in payables for equipment purchases	**(1,681)**	(2,464)
Government assistance for capital items	**10,413**	749
	(45,085)	(34,816)
Financing activities		
Issue of long-term debt	**62,210**	196,047
Repayment of long-term debt	**(1,190)**	(153,948)
Interest	**(80,468)**	(78,065)
	(19,448)	(35,966)
Dividends paid	**(20,500)**	(20,500)
Increase (decrease) in cash	**(9,740)**	809
Cash, beginning of year	**10,452**	9,643
Cash, end of year	**$ 712**	$ 10,452

BC RAIL LTD.
NOTES TO FINANCIAL STATEMENTS
December 31, 1986

1. Significant Accounting Policies

The accounting regulations prescribed by the Canadian Transport Commission for Canadian railways have been adopted to the extent that this is possible without submitting specific accounting policies and depreciation rates to the Commission for approval.

Class of business

The company provides a fully integrated rail freight service within British Columbia. Services other than hauling freight are not of sufficient size to warrant separate reporting.

Road property

New construction is recorded at cost net of Government grants. Abandoned or relocated sections are removed at average unit costs. Elements of track structure installed during planned programs are recorded at cost and the material replaced is removed at amounts which approximate average unit costs. Labour costs for programmed replacements are expensed as incurred.

All costs of constructing rail lines are capitalized to the date the line is certified operational by the British Columbia Ministry of Transportation and Highways. Capitalization of interest ceases and provision of depreciation commences on the date of certification.

Depreciation

Depreciation is provided for major categories of property and equipment on the straight-line basis at composite rates estimated to reduce the original cost to estimated salvage value over the average service lives of the classes. The group method is used for recording depreciation under which, on disposal, the original cost of assets retired less salvage value is charged against accumulated depreciation. No gain or loss on retirements, other than on accidental destruction of rolling stock and on disposal of land, is included in income. The original cost of assets less estimated salvage value is depreciated over the following number of years.

	Number of years
Grades, surfacing and tunnels	100
Rails	35
Ties	15
Ballast	25
Bridges	30-80
Locomotives and power units	25
Freight cars	33

Repairs

Repairs and non-programmed replacements of track structure are charged against current operations. Betterments and major track relocations are capitalized.

Material and supplies

Inventories of material and supplies are valued at the lower of average cost and net realizable value.

Government assistance

Grants directly related to the construction or rehabilitation of road property have offset related road property capital expenditures. Operating assistance has been deducted from the related expense accounts or included in revenue.

Income taxes

Income tax expense is computed on the basis of accounting income recorded by the company. No taxes are currently payable as the company intends to claim certain amounts for income tax purposes in excess of those recorded in the accounts.

Transactions in foreign currency

Transactions originating in foreign currency are translated at the approximate exchange rates prevailing at the dates of the transactions. Assets and liabilities denominated in foreign currency at the balance sheet date are translated to equivalent Canadian amounts at the current rate of exchange.

Leases

Certain long-term lease transactions relating to the financing of equipment are accounted for as purchases. The capital lease obligations reflect the present value of future minimum rental payments discounted at the interest rate implicit in the leases. The capitalized values of depreciable assets are generally depreciated over the related lease terms in equal annual amounts. Costs of all other leases are charged against operations as incurred.

2. Dease Lake Extension

Included in the assets acquired from British Columbia Railway Company were costs related to the uncompleted Dease Lake extension. Construction was suspended in 1977 and there are no commitments to continue. In the event any portion of this extension is abandoned, the cost less any value recovered will be written off at that time.

NOTES

3. Long-Term Debt

Long-term debt outstanding, less current maturities, consists of the following:

	1986	1985
Capital lease obligations – Notes 5 and 10	$ 42,137,000	$ 43,327,000
Deduct current portion	1,249,000	1,137,000
	40,888,000	42,190,000
Notes payable to British Columbia Railway Company		
10.75% due February 1990	25,000,000	25,000,000
10.4% due June 1995	56,350,000	56,350,000
12.75% due July 1995	114,697,000	114,697,000
9.7% due June 1991	62,210,000	–
	258,257,000	196,047,000
Notes payable to BCR Properties Ltd.		
14% due June 1999	402,500,000	402,500,000
	$701,645,000	$640,737,000

4. Share Capital

Authorized

5,000,000 common shares with a par value of $100 each.

20,000,000 first preferred shares with a par value of $25 each of which 8,000,000 are designated as $2.3125 cumulative redeemable retractable first preferred shares, series A.

20,000,000 second preferred shares with a par value of $100 each of which 3,000,000 have been designated as non-cumulative redeemable second preferred shares, series A.

Issued and outstanding	
500,012 common shares	$ 50,001,000
8,000,000 series 1-A preferred shares (Note 5)	200,000,000
1,616,892 series 2-A preferred shares	161,689,000
	$411,690,000

Earnings per common share are not provided as all of the shares are held by British Columbia Railway Company and its wholly owned subsidiary.

5. Commitments

The company has significant lease commitments for rolling stock and additional minor lease commitments for equipment and real estate which expire at various dates prior to the year 2000. Certain of these leases transfer substantially all of the benefits and risks of ownership to the company and are accounted for as capital assets.

The following is a schedule of future minimum rental payments at December 31, 1986 required under non-cancellable leases that have terms in excess of one year.

	Capital leases	Operating leases
1987	$ 6,555,000	$ 16,299,000
1988	6,555,000	15,851,000
1989	6,555,000	15,441,000
1990	6,555,000	13,865,000
1991	6,555,000	12,385,000
Later years	56,246,000	37,191,000
Total minimum lease payments	89,021,000	$111,032,000
Less		
Executory costs	4,093,000	
Imputed interest	42,791,000	
Present value	$42,137,000	

Assets under capital leases recorded in the property and equipment accounts as at December 31, 1986 are as follows.

Equipment	$46,597,000
Accumulated depreciation	11,326,000
	$35,271,000

As at December 31, 1986 the company had outstanding purchase commitments for the acquisition of material and equipment amounting to $10,000,000.

The company must make all reasonable efforts in each quarter to purchase for cancellation in the open market three-quarters of 1% of the series 1-A preferred shares outstanding at the beginning of the quarter at a price not to exceed $25 per share and all transaction costs. If it is unable to fulfill its obligation in any calendar quarter the obligation will carry over only to the successive calendar quarters of the same calendar year and will thereafter be extinguished. During 1986 the company was unable to purchase shares at a price not exceeding $25 per share.

NOTES

6. Contingent Liabilities

The company is contingently liable with respect to pending litigation and claims which arose in connection with construction of the Tumbler Ridge rail line and in the normal course of business. In the opinion of management any liability that may arise will be capitalized or would not have a material adverse effect on future income.

7. Government Assistance

Government assistance was as follows:

	1986	1985
Carried forward from previous year	$ 239,000	$ 1,031,000
Contributions during the year		
From the Province of British Columbia (the Province)		
Fort Nelson extension		
Operating	4,500,000	3,456,000
Rehabilitation	6,599,000	49,000
Passenger operation	2,400,000	2,100,000
Passenger car modernization	527,000	170,000
Other	635,000	800,000
	14,661,000	6,575,000
From the Government of Canada		
Grain transportation	2,769,000	879,000
Rail line rehabilitation	6,250,000	–
Rail line electrification	125,000	–
	23,805,000	7,454,000
	24,044,000	8,485,000
Applied as follows		
Revenue	2,769,000	879,000
Operating expenses	10,095,000	6,618,000
Property and equipment	10,413,000	749,000
	23,277,000	8,246,000
Carried forward to following year	$ 767,000	$ 239,000

8. Interest Expense

Interest expense was as follows:

	1986	1985
Notes payable		
BCR Properties Ltd.	$56,350,000	$56,350,000
British Columbia Railway Company	26,396,000	17,499,000
	82,746,000	73,849,000
Short-term notes payable to the Province	–	3,071,000
Capital lease obligations	5,097,000	5,269,000
	87,843,000	82,189,000
Less interest income		
Related companies	6,298,000	2,974,000
Other	1,077,000	1,150,000
	7,375,000	4,124,000
	$80,468,000	$78,065,000

9. Pension Plan

The majority of the company's employees participate in a contributory pension plan and are entitled to limited vested rights prior to retirement. An actuarial valuation as at May 31, 1986 disclosed that the plan was fully funded.

10. Related Party Transactions

Related party information not presented elsewhere in the notes to financial statements is presented below.

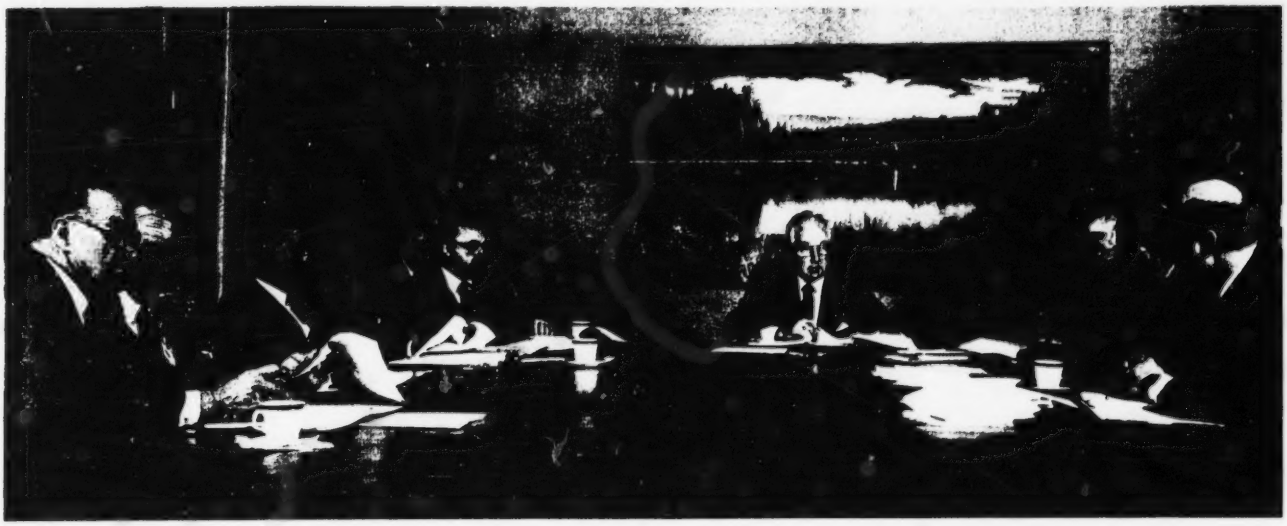
All of the outstanding common and second preferred shares of the company are owned as follows:

BCR Properties Ltd. (a wholly-owned subsidiary of British Columbia Railway Company)	75%
British Columbia Railway Company	25%

First preferred shares and certain capital lease obligations are guaranteed by the Province. The Ministry of Finance of the Province acts as fiscal agent in the administration of the debt and the Superannuation Commission of the Province administers the company pension plan. Fees are charged for both of these services.

The company is subject to all taxes levied by the Province except property and capital taxes. All other transactions between the company and the Province are at terms no more or less favourable than those with unrelated parties.

CONTACT INFORMATION



Directors and management committee members at scheduled Board meeting.

NOTICE OF SPECIAL MEETING
For Non-voting Preferred Shareholders

In accordance with the practice established in previous years, the Board of Directors and Management of BC Rail Ltd. cordially invite preferred shareholders to an informational meeting on June 18th, 1987. The meeting will start at 10:30 a.m. and be held in the Arbutus Room of the Four Seasons Hotel, 791 West Georgia Street, Vancouver, B.C.

The meeting is not a legal requirement and is offered as a courtesy to the company's preferred shareholders. Its purpose is to report on company activities and performance during 1986 and on the outlook for the coming operational year. The informational meeting is open to the public. It follows the company's Annual General Meeting, which is open only to common shareholders, directors and officers of the company.

For further information, please call: **Ms. C. A. Lee,**
(604) 984-5291

About the cover

On the cover is a rendering of motive power throughout the railway's history, from the tiny PGE No. 1 (purchased in 1912), to the 6,000-hp electric locomotives that serve the northeast coalfields on the Tumbler subdivision.

The illustration, by North Vancouver artist Robert Banks, was commissioned by BC Rail to commemorate the railway's 75th anniversary, 1987.

This watercolor will be available later in 1987 as a lithograph. If you would like a copy, or if you would like additional copies of the annual report, please write to:

BCRAIL

Corporate Information Department
P.O. Box 8770
Vancouver, B.C. V6B 4X6
(604) 986-2012

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